

97-84048-20

Eckert, John A.

Use and occupancy
insurance

[New York]

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Box 131	Eckert, John A.
	Use and occupancy insurance; an address delivered before the one hundred and thirty-seventh meeting of the Insurance society of New York on November 14th, 1916, by Mr. John A. Eckert ... [New York, Printed by C. H. Jones & co.] 1916.
	13, (2) p. 23 ^{cm} .
	Bibliography: 1 p. at end.
	1. Insurance, Fire. I. Title.
	Library of Congress
	Copyright A 455007
	HG9669.E4
	17-7170
	ONLY ED

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TECHNICAL MICROFORM DATA

FILM SIZE: 35 mm

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IMAGE PLACEMENT: IA IIA IB IIB

DATE FILMED: 3-24-97

INITIALS: B

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Use and Occupancy Insurance

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AN ADDRESS

Box 131

DELIVERED BEFORE THE ONE HUNDRED AND
THIRTY-SEVENTH MEETING OF

The Insurance Society of New York

ON

November 14th, 1916

BY

Mr. John A. Eckert

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Sept. 13, 1923, p. 17

Use and Occupancy Insurance.

When our President asked me to prepare this address, and I promised to do so, I did not realize the extent of the contract which I had entered into. When I applied myself to the task, I found that the subject, so far as it is understood, had been so capably presented in various addresses and pamphlets by several well-known members of the Insurance Fraternity, expert in the art of underwriting and adjusting, that I began to see that it would be difficult to explain more clearly than had already been explained this elusive form of insurance which we call "Use and Occupancy."

One of my adjuster friends, who has had some experience in Use and Occupancy losses, said to me when I told him I was preparing this paper: "Well I admire your nerve. You cannot help making a goat of yourself. If I had a grudge against you I would take a seat in the front row and grin at you."

I have heard a rumor to the effect that several experienced insurance men when asked at one time or another to say something on this subject have held up their hands and said: "Nay, nay."

I am, therefore, impressed with my incompetency to explain to you what Use and Occupancy Insurance really is, other than that it is generally understood to cover as many kinds of indirect and consequential losses resulting from the burning of a manufacturing plant as there were colors in Joseph's coat. I trust that you will accept what I may say on this subject as the views of one man only.

We workers in the insurance profession are influenced by our respective occupations, and subjects of this character are liable to be viewed from one angle by the underwriter and the adjuster, and from another angle by the broker.

The experience of the underwriter and the adjuster is derived from a review of many claims presented under all kinds of conditions, from which he judges a certain class of insurance, and because of this experience, with all that it implies, the underwriter and the adjuster are liable to view a unique or unusual form of insurance with caution.

The broker, on the other hand, while perhaps not having as much experience in the matter of technical adjusting, looks at unique and unusual forms of insurance from a much different viewpoint, because, in his profession, he meets thousands of insurers who desire only reimbursement for their actual losses and pay their premiums and expect to receive such reimbursement if a loss occurs. Among these thousands there is only an occasional loss claimant.

It seems to me, therefore, in order to be able to say anything on this subject which has not already been said, that I must discuss it along the line of my experience, somewhat from the standpoint of the public, and endeavor to justify its existence, and attempt to minimize the doubts and fears which are so often expressed by underwriters as to the wisdom of writing this form of insurance.

It appears that Use and Occupancy Insurance was first written in this country through the efforts of two prominent New England insurance men, interested in stock company insurance, who induced a number of prominent companies to write this class of insurance on highly protected New England factories; in fact, it is said that their object in doing so was to make up to the stock companies premiums lost to the New England Mutual Insurance Companies, and to offer this form of coverage in connection with straight insurance against fire damage in order to defeat the competition of the New England Mutual Companies who were not then prepared to write it.

It would seem that the ideas of the promoters were sound, and their efforts successful, for we find now that Use and Occupancy insurance is very generally carried by the large mill owners throughout New England and elsewhere, and the New England Mutual Insurance Companies write it quite as freely as do the Stock Companies.

It has been suggested that the term "Use and Occupancy" might very well be discarded, and another name applied to this form of insurance which would more clearly describe its character. The term "Business Interruption Indemnity" has been suggested. Whether or not this suggestion is a good one depends entirely on whether a uniform contract will eventually be adopted or come into common use by the companies which will clearly define the coverage.

In view of the many different forms of contract which are now being used, which result in many wide differences in the

matter of loss payments under Use and Occupancy policies, something should be done for the guidance of the public and for the purpose of enabling the companies to determine how to underwrite this class of insurance by way of providing a standard form of contract so that the public may at all times know what a Use and Occupancy policy means, and the companies may at all times know what their liability is under such policies.

Several companies have adopted their own Use and Occupancy forms, but it is my opinion that they very rarely have an opportunity to use them unless they take the order for the insurance direct from the assured or are dealing with an agent who has very little knowledge of the subject. Most all large agencies have their own form, and most every large brokerage office has its own form, with the result that we very rarely see two forms alike, and by this is meant alike as to application and coverage.

The following insuring clause is taken from a form in somewhat general use and is quoted as a basis for the discussion of this subject. It is by no means the only form used, but it is a fair sample; with few exceptions the clauses are the same or if the words are not the same the meaning is practically the same:

"On the use and occupancy of premises situate.....

.....
It is understood that if by reason of fire, the assured shall be wholly prevented from producing their product or conducting their business, then this Company shall be liable for \$..... per diem for each working day from date of said fire to date (whether the same fall within the term of this policy or not), when the normal production of their product has been resumed, or could with reasonable diligence be resumed; but if the normal production is diminished only then shall this Company be liable for that proportion of said per diem in which said production is diminished. In case the production be diminished by fire, as above specified, the average daily production for the twelve months in which the plant has been in full operation immediately preceding the fire, shall, for the purpose of this insurance, be assumed to be the normal daily production. This Company shall not be liable for more than the amount of this policy."

Let us take the terms "shall be wholly prevented from producing their product or conducting their business."

There have been several controversies in the adjustment of Use and Occupancy losses arising over the question as to whether the disablement by fire of a certain department of a manufactur-

ing plant, preventing the completion of finished product, constituted a total per diem loss. Unless a plant is totally destroyed it is likely that certain departments will be left intact and capable of performing their work; therefore, in such a case the words "wholly prevented from producing their product" would have to be construed in a spirit of fairness by the adjuster and the assured. An assured could hardly expect to collect a total per diem loss if he is operating a part of his plant, and if he is doing a prosperous business and is desirous of filling his orders he would no doubt prefer to operate such part of his plant as it would be possible, and accept, from the insurance companies, a reduction from his per diem loss, unless the conditions of his business were such that it would be impossible for him to do so.

Forms have been issued reading:

"Shall be wholly prevented from producing finished goods."

But to hold an insurance company for a total loss because of this phraseology, when it would be possible to advantageously operate part of the plant, would be unfair, and would result in discouraging the companies from writing this class of insurance, except under a limited form which would make this class of insurance less attractive to many insurers who desire to be fair in the adjustment of their losses and to collect only the measure of their actual loss.

The words "or conducting their business" in the above form appear to be inserted to cover risks, part of which are occupied as sales or distributing departments. There are many such risks where the product is manufactured in part of the premises and removed to another part for storage, sale or distribution, and the loss or damage to such product while on storage, sale or distribution, if located in premises occupied in part for the manufacturing of the product, would quite as readily result in a Use and Occupancy loss as would the stoppage of manufacturing should the fire occur in the manufacturing part of the plant.

"Shall be liable for \$. per diem for each working day."

This phraseology seems to make the contract a valued policy. Some companies insist upon inserting the words "not exceeding" before the stated amount payable per diem, which insertion apparently takes from the contract the valued feature thereof and would necessitate the proving of a loss by items and figures in detail.

"Shall be liable * * * to date when the normal production of product has been resumed or could, with reasonable diligence, be resumed."

This feature of this form makes the term for which the companies are liable for the per diem loss a matter of adjustment on the same basis as a rent loss would be determined, by arriving at the time when production could be resumed; amicably, if possible, or otherwise by appraisal.

The latter part of the above form which provides, in case of partial stoppage of product, that the loss shall be settled on a percentage basis, based upon the average normal production for the twelve months in which the plant has been in full operation immediately preceding the fire, might result in a surprise party either for the company or the assured, depending upon the capacity at which the plant was operating at the time of the loss, as follows:

The normal daily production of a plant for the twelve months preceding a fire might be \$3,000 per day. In these times the same plant might be running at double its capacity, as many plants are now running, and the production valued at \$6,000 per day. If a fire should occur and result in a 50 per cent. stoppage it is evident that the stoppage would amount to \$3,000 per day. 50 per cent. of the normal daily production for the twelve months preceding the fire, however, would figure out \$1,500 per day. The remedy for this condition would seem to be for the insured to revise and increase his Use and Occupancy insurance at times of extraordinary production. This condition of affairs would operate in an opposite manner if a fire should occur in a dull period following an extraordinary busy period.

Where the product of a plant is known to fluctuate during the year, with a large output in certain months and a small output in other certain months, brokers and agents have been known to provide in the policy for the payment of a greater per diem sum during the period of large output and a lesser per diem sum during the period of small output.

It is sometimes argued that there is no co-insurance feature in connection with Use and Occupancy insurance. I believe, however, that it is the usual practice for companies to demand, and for brokers and agents to issue, policies in amounts equal to three hundred times the daily per diem amount stated in the policy. This practice provides a fair substitute for a co-insurance clause.

Use and Occupancy insurance is written to cover against the hazards of explosion, windstorm, sprinkler leakage and lightning, the lightning hazard usually being included in the policy against fire. There has been considerable explosion Use and Occupancy written during the last year or so.

There are so many technical questions involved in the adjustment of Use and Occupancy losses, and so many different views indulged in by the assured, agent, broker and adjuster as to the coverage, that the inclusion or omission of a word or two here or there in the form may alter the entire aspect of the contract, and result in a controversy as to the amount of the loss, thus causing dissatisfaction on the part of either the companies or the assured.

The elements of this class of insurance on which there seems to exist differences of opinion are:

First—Whether some of the contracts used constitute valued policies and whether, as a matter of good underwriting practice, valued policies should be issued or whether the assured, in case of loss, should be obliged to prove his loss by items and figures.

Second—Whether this class of insurance creates a severe moral hazard and should be avoided for that reason, and for the further reason that if freely written it would increase the moral hazard in connection with the insurance on the buildings and contents of the same risk.

Third—Whether it is a blanket policy covering rents, profits and leasehold interest under the name of "Use and Occupancy."

Mr. W. N. Bament in a very able article on this subject, written about four years ago, says:

"There has been a feeling, which still exists in some quarters, that this class of insurance tends to increase the moral hazard, but probably on account of the discriminating care on the part of companies in selecting their risks the record thus far has failed to justify these fears."

Whether or not Mr. Bament has had reason to change these views since 1912 I do not know, but it seems evident that his views on this subject are far-reaching by reason of his large experience as an adjuster and his association with a company writing a considerable volume of this business.

As to whether the forms of contract at present being used constitute valued policies depends entirely on how such forms are constructed. Probably many of the contracts now in force are valued policies, while there are many which are not. There seems to be little doubt that this form of insurance can be made

valued, depending upon the ability of the agent or broker in preparing his form, and that valued insurance can be obtained, depending upon whether the underwriters will accept such forms.

The next question which arises is as to whether it is good practice, from an underwriting standpoint, for companies to accept forms which constitute valued policies. It is needless to say that at the same rate the valued policy is more acceptable to the assured. In these times of aggressive business methods large firms direct their energies and efforts in many ways and in many places and at large expense for the purpose of selling their product. It is apparent that reimbursement for physical damage to buildings, machinery and stock at market prices, only partially covers the loss of such firms. Many of them maintain agencies throughout the country with fixed expenses, which must necessarily be continued at a loss unless the product which they are employed to sell is forthcoming from the source of production. If the plant is seriously crippled by fire these agencies cannot be discontinued without crippling the business organization. These same firms may be employing a force of traveling salesmen whose services cannot be dispensed with without injury to the business, and they may be carrying advertising expenses which cannot be very well discontinued. The agencies, the salesmen and the advertising are expense factors not a part of the physical plant, but they result in a serious loss if the operation of the plant is interfered with. The plant taxes are not abated when fire occurs, and if bonds or mortgages exist the interest on them must be paid, and trained and experienced heads of departments, executives, etc., must be kept on the payroll, as well as many other similar and less important expenses continued while the plant is unproductive. Furthermore, a fire may occur in a plant, the product of which must be delivered in time to supply a season trade. If such plant should be seriously damaged by fire the season's business could be lost, resulting in a financial loss which it would be difficult to calculate.

All of these items seem to constitute proper insurable hazards and now we come to the question of insuring profits.

If the valued feature of these contracts, which are in general use, is eliminated, then I believe there is grave doubt as to whether fixed expense charges which do not apply to the plant would have to be admitted by the adjuster, or, in other words, if the form is not a valued one, specific or general language should be used to clearly set forth just what the policy covers in much

the same manner as we describe property covered under regular fire insurance policies; for instance, a form such as is generally used to cover machinery.

Why should not a reputable concern, doing a prosperous business, be able to insure against the loss of profits in order that their dividends may continue and their surplus be protected from depletion?

It may be said that all of these losses are subject to proof and that there is no justification for the issuance of a valued policy. The answer to this assertion is that there is grave doubt as to whether losses of this character can be proved without controversy between the insured and the adjuster and a resort to compromise.

If it is the purpose of the company, in issuing a Use and Occupancy policy, to protect the insured against loss resulting from the interruption of his business, and if the Company is averse to issuing a valued policy, then the form should be so constructed as to cover all of the factors referred to, which would result in loss; and if such a form is written and all of such factors included in the loss, it would seem as though the insured, if he chose, could present a formidable claim which it would be very difficult for the adjuster to analyze.

If the foregoing statements are sound it would seem that a valued form of policy will, in the long run, prove most satisfactory. It will give the assured what he needs and pays for, and if his loss exceeds the amount of insurance which he carries, he can have no complaint. It makes possible more easily adjusted losses without controversy, which sometimes injures the reputation of the insurance companies.

The real solution of this problem, from the company standpoint, is careful and thoughtful underwriting. It is an accepted fact that no prosperous concern can afford to have a serious fire, no matter how well they are insured. The underwriter has facilities for learning whether an applicant for Use and Occupancy insurance is a prosperous concern. He can review the character of the business conducted and the machinery in use, and determine whether same can be properly replaced or repaired, and thus inform himself as to whether his per diem loss is likely to extend over an abnormally long period by reason of the inability of the insured to promptly rebuild his building, equip it with machinery and replenish his stock of raw material to enable him to begin operations as soon as possible after the fire.

There is no doubt that a large majority of Use and Occupancy risks, when selected with care by the underwriter, have proved a profitable form of insurance. It is true, however, that here and there a loss has occurred and a claim made which has proved troublesome. The factors which have resulted in troublesome adjustments have no doubt largely consisted of inability to replace machinery, to secure raw material, and unreasonableness on the part of the assured. These are factors which can be foreseen to some extent at least at the time of the issuance of the policy.

It should be an easy matter for an inspector, if he would depart from the beaten path, to ascertain whether the machinery in the plant is of foreign make, and whether it can readily be replaced if of domestic make. At present the inspection report often deals with the conditions of construction, protection and exposure only.

As to the attitude of the assured, I cannot believe that a prosperous concern, doing a staple business, would be content to allow its plant to be shut down and remain idle for the sake of collecting a few hundred dollars per day Use and Occupancy loss, while orders are waiting to be filled, if it were possible for them to put their plant in an operative condition. Therefore, it seems to me, that whatever bad experience the companies have had in this class of insurance, which has resulted in criticism of it as a class, has resulted from a lack of the same discrimination which the companies generally exercise in accepting ordinary fire risks. If all this is so, and this business is profitable as a whole, it is high time that the companies adopt a more discriminating method in selecting their risks, by refusing to approve applications on risks which may lead to troublesome losses for reasons stated above.

Use and Occupancy Insurance, as a class, should not be viewed with alarm because of this lack of discrimination. On the other hand, I believe it would prove to the advantage of the companies if they were to make an effort to increase their volume of this class of business, properly selected. Neither should Use and Occupancy insurance be considered in the light of an experiment, and the broker specializing in this class of insurance and writing a large volume of it should be credited with doing a constructive work, and not be considered as engaging in undesirable practices.

There is a speculative element associated with Use and

Occupancy insurance, when written under a valued form, which has not been referred to in any of the papers or speeches which I have read and heard on the subject. Under the present underwriting methods an insured is at liberty to carry as much Use and Occupancy insurance as he is willing to pay for. This permits an insured, knowing that he has a plant subject to probably total destruction, to carry insurance in excess of all probable loss. For instance, a man with a plant such as I have referred to, who might easily cover all his indirect losses with Use and Occupancy insurance amounting to \$60,000, which would provide for the payment of \$200 per day, might figure that it would be a good speculation for him to carry insurance to the amount of \$120,000, thus enabling him to collect \$400 per day. Such an act would not be considered exactly honest by the underwriter, but the average business man, not being imbued with the spirit of "Indemnity Only" which exists in the mind of the underwriter, would not think there was anything wrong in effecting excess insurance under such circumstances, so long as the companies were willing to issue the policies and accept his premium.

This may constitute a dangerous feature in Use and Occupancy underwriting, but such a practice could easily be obviated by the underwriter demanding information as to the total insurance carried on Use and Occupancy by the insured whose application he is considering, and he might also properly demand that the total amount of insurance carried be stated in the policy. He could then, by investigation, determine whether that assured was justified in carrying that amount of Use and Occupancy insurance. If he is willing to issue a liberal policy he is entitled to be surrounded by some safeguards in connection with its issuance.

I believe that Use and Occupancy is an entirely sound and justifiable form of insurance which if carefully considered before writing will prove just as profitable to underwriters as any other form. It does embrace some of the features of rent insurance, profit insurance and leasehold insurance, but that is no reason why the underwriter should say to the manufacturer we will not cover you for Use and Occupancy insurance—insure your rents separately if you are liable for them, or your rental value if you own the building, and insure your leasehold interest if you have an insurable hazard therein, or insure your profits separately. I believe that the same underwriting skill and thought should be applied to this class of insurance as is applied to insurance against physical damage to property, and that with such applica-

tion of skill valued policies can be written, and the volume of this business very largely increased. It is volume and average from which the underwriter can best judge whether a class of business is profitable or not.

A much larger volume of Use and Occupancy insurance can be written and should be written if companies will issue a liberal form of policy for assureds whose records show that they are entitled to same, and agents and brokers will give more attention to this class of business and explain its features to their clients. It must be remembered that there are certain advantages to the underwriter in this form of insurance which he does not always enjoy in settling a loss on physical property.

For instance, a plant may be totally destroyed, involving a total loss on buildings, machinery and stock, which would result in a much less than total loss on Use and Occupancy, allowing that the plant could be replaced in less than twelve months. Again a plant might be visited by fire and a delicate stock very severely damaged, resulting in a large loss on stock, which would result in only a moderate loss on Use and Occupancy because the plant could be put in operation in a short time.

Even though valued policies are issued the assured is under obligations to put his plant in running order in as short a space of time as possible, and the company has a right to demand that he does so. Many claimants will endeavor to secure as liberal a settlement as possible on buildings, machinery and stock, and at the same time will put forth every energy to get their plant in running order as soon as possible.

In the first instance their interest lies in making as liberal a settlement as possible, while in the second instance their interest lies in rebuilding and operating their plants as promptly as possible, thus reducing the Use and Occupancy loss, because of the ever-prevailing competition in business, threatening that greater and uninsured loss—the loss of trade, the diversion of customers, in the upbuilding and acquirement of which years of effort and large expenditures of money have been invested.

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Use and Occupancy Inspection Blank. Fire Underwriters' Uniformity Association, 175 West Jackson Boulevard, Chicago, Ill.

PRINTED DECEMBER, 1916

MSH 22643

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